

REPORT OF EXAMINATION
OF THE
SURETY COMPANY OF THE PACIFIC
AS OF
DECEMBER 31, 2004

Filed December 20, 2005

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Los Angeles, California
September 23, 2005

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

SURETY COMPANY OF THE PACIFIC

(hereinafter also referred to as the Company) at its home office located at 6345 Balboa Boulevard, Suite II-325, Encino, California 91316.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2000. This examination covers the period from January 1, 2001 through December 31, 2004. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of assets and a determination of liabilities as of December 31, 2004, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; and sales and advertising.

SUMMARY OF SIGNIFICANT FINDINGS

Subsequent to the examination date, the Company's financial operations continued to deteriorate. The Company's June 30, 2005 quarterly financial statement reported a year to date net loss of \$459,099. This loss may adversely affect the Company's risk based capital (RBC), which was at 231% as of year end 2004. Given the downward trend of the Company's surplus and its RBC ratio, it appears that the Company needs to address the factors which contributed to its overall weakened financial status and resolve its downward trend. It is recommended that the Company develop a Comprehensive Surplus Plan and present it to the California Department of Insurance for review.

COMPANY HISTORY

The Company was incorporated under the laws of California on December 3, 1968 and commenced business on February 14, 1969. The Company is wholly-owned by Mr. Montgomery Erwin, as Trustee of the M&L Erwin Trust. As of December 31, 2004, the Company had 40,000 shares of common stock authorized, and 5,000 outstanding shares with a par value of \$200 per share.

During the examination period the Company paid cash dividends totaled \$1,160,000. These dividends were \$550,000 paid on December 10, 2001, \$210,000 paid on December 31, 2001 and \$400,000 paid on June 9, 2003. All dividends were approved by the California Department of Insurance.

MANAGEMENT AND CONTROL

Management of the Company is vested in a one-member board of directors elected annually. A listing of the board and principal officers serving on December 31, 2004 follows:

Director

Name and Residence

Principal Business Affiliation

Montgomery Erwin
La Canada, California

Chairman and Chief Executive Officer
Surety Company of the Pacific

Principal Officers

Name

Title

Paul R. Geissler

President

Tanis M. Galik

Secretary

Sharon R. Ahlschwede

Treasurer

George A. Peate

Senior Vice President

Suzanne C. Chiasson

Vice President

Melita Danie

Vice President

Kathleen K. Goodwin

Vice President

Maria D. Thompson

Vice President

Mary K. Weldon

Vice President

Custodial Agreement

The Company has a custodial agreement with City National Bank. The custodial agreement has been submitted to the California Department of Insurance for approval in accordance with California Insurance Code Section 1104.9. Approval of the custodial agreement is pending.

TERRITORY AND PLAN OF OPERATION

The Company is licensed to transact surety business in the State of California. The Company also holds a certificate of authority issued by the United States Department of Treasury to write federal bonds. The Company had direct premiums written of \$13.1 million in 2004.

The Company specializes in contractor's license bonds with a face value of \$10,000. This represents 95% of the direct premiums written, with the balance comprised of standard contract surety bonds and performance and payment bonds.

The Company's business is produced by approximately 2,000 independent agents located throughout California. Commissions to the agents range between 20% and 35%.

LOSS EXPERIENCE

The following is a summary of the loss experience reported by the Company for the years under examination:

Year	Net Underwriting (Loss)	Net Income Gain Or (Loss)
2001	\$ (449,333)	\$ 391,921
2002	(403,088)	328,420
2003	(1,029,829)	(277,761)
2004	(1,461,745)	(925,662)

The Company reported net underwriting losses for all years under examination and net losses in the last two years. In total, the Company reported underwriting losses of \$3.3 million and a net loss of \$483,082 for the examination period.

REINSURANCE

Assumed

The Company did not assume reinsurance during the period under examination.

Ceded

The Company's ceded reinsurance is with Endurance Reinsurance Corporation of America, (ERCA). The Company's retention is \$250,000 for contract surety bonds. The reinsurer liability is \$750,000 per bond on the first \$1 million and is subject to an annual aggregate of \$2,250,000 on all bonds and principals. Additionally, the Company has a general reinsurance agreement with ERCA. Under this agreement ERCA will accommodate larger contract surety bonds on a facultative basis.

ACCOUNTS AND RECORDS

The Company has two separate and distinct claims reporting systems. One system, the claims tracking system, tracks a claim from the time a claim is reported to when it is settled. The other claims system, the accounting claims system, establishes a claim when a claim is paid or when a lawsuit is initiated. As of December 31, 2004, the claims tracking system included over 900 claims which are not listed on the accounting claim system. The accounting claims system also does not include the total number of claims reported, outstanding claims or claims closed without payment.

Although the Company enjoys the protections inherent to a surety, any claims applicable on a contractor's license bond, performance bond or any related claim brought against the principal are potential claims against the surety. It is recommended that the Company report the additional claims included in the claims tracking system to the claims accounting system in order to represent a true claim count in its Annual Statement.

The Company stated that it does not establish a reserve for unpaid non-lawsuit claims because the majority of claims are settled directly between the principal and the claimant or not covered by the surety

FINANACIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2004

Underwriting and Investment Exhibit for the Year Ended December 31, 2004

Reconciliation of Surplus as Regards Policyholders
from December 31, 2000 through December 31, 2004

Statement of Financial Condition
as of December 31, 2004

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 12,290,477	\$	\$ 12,290,477	
Stocks:				
Common stocks	1,910,745		1,910,745	
Cash and short-term investments	4,677,694		4,677,694	
Investment income due and accrued	147,255		147,255	
Agents' balances or uncollected premiums:				
Premiums and agents' balances in course of collection	381,724		381,724	
Federal income tax recoverable	100,000		100,000	
Net deferred tax asset	508,240		508,240	
Electronic data processing equipment and software	22,920		22,920	
Other assets nonadmitted	<u>243,055</u>	<u>243,055</u>	<u>0</u>	
Total assets	<u>\$ 20,282,110</u>	<u>\$ 243,055</u>	<u>\$ 20,039,055</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 1,692,725	(1)
Loss adjustment expenses			2,169,960	(1)
Other expenses			56,586	
Taxes, licenses and fees			101,105	
Borrowed money			31,937	
Unearned premiums			10,652,549	
Advance premiums			869,532	
Drafts outstanding			145,593	
Aggregate write-ins for liabilities			<u>2,755</u>	
Total liabilities			15,722,742	
Common capital stock		\$ 1,000,000		
Gross paid-in and contributed surplus		1,588,662		
Unassigned funds (surplus)		<u>1,727,651</u>		
Surplus as regards policyholders			<u>4,316,313</u>	
Total liabilities, surplus and other funds			<u>\$ 20,039,055</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2004

Statement of Income

Underwriting Income

Premiums earned		\$ 10,398,289
Deductions:		
Losses incurred	\$ 1,496,811	
Loss expenses incurred	3,170,586	
Other underwriting expenses incurred	<u>7,192,637</u>	
Total underwriting deductions		<u>11,860,034</u>
Net underwriting loss		(1,461,745)

Investment Income

Net investment income earned	\$ 550,421	
Net realized capital losses	<u>(7,963)</u>	
Net investment gain		542,458

Other Income

Net loss from agents' balances charged off	\$ (866)	
Aggregate write-ins for miscellaneous income	<u>(5,509)</u>	
Total other income		<u>(6,375)</u>
Net loss before dividends to policyholders and before federal income taxes		<u>(925,662)</u>
Net loss		\$ <u>(925,662)</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2003		\$ 5,082,403
Net loss	\$ (925,662)	
Change in net unrealized capital gains	158,937	
Change in net deferred income tax	15,840	
Change in nonadmitted assets	<u>(15,205)</u>	
Change in surplus as regards policyholders		<u>(766,090)</u>
Surplus as regards policyholders, December 31, 2004		\$ <u><u>4,316,313</u></u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2000 through December 31, 2004

Surplus as regards policyholders, December 31, 2000 per Examination			\$ 5,668,809
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net loss	\$	\$ 483,082	
Net unrealized capital losses		18,219	
Change in non-admitted assets	42,560		
Change in net deferred income tax		55,702	
Dividends to stockholders		1,160,000	
Surplus adjustments: Paid-in	72,468		
Aggregate write-ins for losses in surplus		40,425	
Cumulative effect of changes in accounting principle	<u>289,905</u>		
Totals	<u>\$ 404,933</u>	<u>\$ 1,757,428</u>	
Net decrease in surplus as regards policyholders			<u>(1,352,495)</u>
Surplus as regards policyholders, December 31, 2004, per Examination			<u>\$ 4,316,314</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

A Casualty Actuary from the California Department of Insurance (CDI) reviewed the work performed by the Company's independent actuary. The CDI actuary found that the reserves for losses and loss adjustment expenses were deficient by \$148,000. Since the reserve deficiency was below the materiality level, no changes to the reserves were made.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Summary of Significant Findings: (Page 2): It is recommended that the Company develop a Comprehensive Surplus Plan and present it to the California Department of Insurance for review.

Accounts and Records: Losses (Page 5): It is recommended that the Company report the additional claims included in the claims tracking system to the claims accounting system in order to show a true claim count in its Annual Statement.

Previous Report of Examination

Accounts and Records: Information System Controls (Page 6): It was recommended that the Company make appropriate changes to strengthen its information system controls. The Company has complied with this recommendation.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/

 Gint Prismantas, CFE
 Examiner-In-Charge
 Associate Insurance Examiner
 Department of Insurance
 State of California